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The Monetary Mirage

"As finance is but the handmaiden of industry, it follows that the test of the normalcy in the rate of credit expansion is the relationship which it bears to the rate of growth of industry and trade . . . if the rate of credit rises above the rate of business growth, we have a condition of inflation which manifests itself in rising prices in some parts of the business structure, overconfidence, excessive speculation, and an eventual crash."

National City Bank, Monthly Economic Letter
April, 1929

The worm has turned on Wall Street, and so have speculative attitudes towards the Federal Reserve. Hopes for a steady progression of Fed interest rate cuts – so prevalent as the year began – have given way to fears of future tightenings, once the Fed's customary election-year hiatus is over.

In this issue, we address some of the misleading notions which have so shaken the markets. Once again, we would say, Wall Street is looking at the wrong things in the wrong way at the wrong time. In particular, we see a complete misunderstanding of monetary fundamentals in the industrialized countries, leading to misguided dread of a coming acceleration in consumer- and commodity-price inflation.

At the moment, those fears are proving self-fulfilling. Speculative fever has taken hold of the commodities markets, adding impetus to a weather-related spike in grain prices and an equally transitory run up in oil prices stemming from abnormally low global inventories.

Remarkably, the inflation scare is confined to the United States, kindled by strong U.S. employment and money growth, and by the expectation of a strong economic rebound. Europe's worry is recession and unemployment, not inflation. The only truly overheating economies are those of the "Tiger" countries of the Far East.

Where will the excess demand come from to fuel a global inflationary spiral? Wall Street thinks it sees the answer in the monetary aggregates. The global money supply, we are told, is exploding, thanks to the furious reflation efforts of the major central banks. The inevitable result: a synchronized global recovery that will eliminate the remaining slack in the G7's laggards and quickly push the U.S economy beyond its full-employment potential. Consumer inflation is sure to follow.

The entire argument rests on a foundation of sand. The alleged monetary explosion is a chimera, primarily produced by the unprecedented rise in international dollar reserves, which we have documented at length in past letters. Yet this orgy of dollar buying by foreign central banks has failed to generate the monetary growth hailed by the commodity bulls. Outside of the United States and Britain, broad money growth in the G7 is sluggish at best.

Even in the United States, there is less to the recent uptick in M2 than meets the eye. To a large extent, it reflects a shift in credit expansion from nonbank lenders to banks, and a parallel shift in bank funding from nonmonetary liabilities – chiefly repos and Eurodollars – to time deposits, which are part of M2. Overall nonfinancial credit growth is by far the more relevant aggregate for the real economy. We see no evidence of acceleration there.

Soon enough, we suspect, renewed signs of U.S. economic weakness will put an end to the commodity inflation scare. But we are hardly so sanguine about the inflationary bubble raging in asset markets worldwide. Financial credit growth remains excessive, and highly dangerous.

WALL STREET TAKES A U-TURN

On February 26 of this year, we read the following headline in the *Wall Street Journal*: "Wall Street is Dogged by Slowdown Worries." Yet within a fortnight, both stocks and bonds nose-dived, taking with them the prevailing consensus view of a moderating economy associated with low inflation and falling interest rates. The culprit was the February employment report, which showed explosive job and falling unemployment.

In a flash, out went the old anticipation of sluggish economic growth and sure-fire Fed easing. In came the new expectation of a U.S. economy rapidly firming, if not in danger of overheating later this year, raising the threat of possible Fed tightening. Adding to market jitters, inflation worries were stoked by soaring commodity prices. The rise in the widely followed Commodity Research Bureau Futures Index, which hit an eight-year high on the back of skyrocketing oil and grain prices, attracted wide publicity.

In trying to assess the recent crop of economic numbers, we start with three critical facts:

- While almost all of January's data were distorted to the low side by extremely bad weather and the federal government shutdown, the February numbers essentially exaggerated on the high side.
- The resulting distortions have been additionally skewed by stereotypical seasonal adjustments.
- Employment growth definitely is not a leading indicator.

Actually, it has often been a misleading indicator in the past. So it was early last year. In the first quarter of 1995, nonfarm payrolls rose 678,000 (originally reported as a 717,000 rise), making for a monthly average increase of 226,000. Yet even with this stronger employment growth, the U.S. economy tumbled to the edge of recession. Real GDP growth in the first two quarters of 1995 edged up at annual rates of just 0.5% and 0.6%, respectively. For the year as whole, growth totaled a mere 1.3%.

Payroll growth in the first quarter of this year was even weaker than in the same 1995 period, amounting to 618,000 jobs, or an average 206,000 per month. An added negative: Part-time jobs accounted for 38% of total job growth, as against 14% in the first quarter of last year. In fact, hours worked fell last quarter. Historically, that has signaled economic sluggishness, not strength.

In the same vein, we take the surge in the CRB in stride. The rise has not been broad, reflecting mainly a 50% rise in grain and oil-seed prices, resulting from a bad harvest and strong foreign demand. Oil and natural gas prices also are up between 25% and 40%, driven by low inventories and speculation. But prices of industrial commodities generally are down from a year ago.

It is true that past bursts of commodity-price inflation frequently have coincided with outbursts of consumer-price inflation. The worst case in modern memory was in 1973-74, when the price effects of terrible harvests and a major U.S. wheat sale to the Soviet Union were compounded by the Arab oil embargo and the subsequent quadrupling of global oil prices.

But what really conditioned the ensuing general price explosion in the United States was the legacy of a booming economy, which had expanded at a real annual rate of better than 6% in both 1972 and 1973. Obviously, that's a far cry from today's lackluster growth pattern in the industrialized countries.

The bottom line: In the absence of sharply accelerating economic growth, there simply is no chance for this narrow surge in grain and oil prices to escalate into sustained, accelerating consumer inflation. Quite to the contrary, the temporary price effects may in various ways weaken economies that already are struggling with significant constraints, not least the adverse interest-rate effects set in motion by the inflation scare.

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (April 30)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12 Mo. Lo
Australia	2.1%	5.2%	13.0%	-0.4%	18.1%
Canada	3.5%	9.2%	20.3%	-0.1%	20.7%
France	5.0%	14.7%	11.9%	0.0%	24.7%
Germany	0.8%	11.2%	24.3%	-1.8%	23.8%
Hong Kong	0.1%	8.8%	31.1%	-5.4%	33.5%
Japan	4.8%	12.9%	33.5%	0.7%	54.9%
Mexico	3.7%	14.7%	62.6%	-3.0%	64.4%
Spain	5.9%	12.5%	32.1%	-1.0%	31.3%
U.K.	3.2%	3.5%	18.7%	-1.0%	18.6%
U.S.	1.3%	6.2%	27.1%	-1.1%	27.2%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (April 30)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	8.73	-17	46	-96	-97	76
Canada	7.79	16	71	-57	-68	85
France	6.40	-21	-23	-142	-148	13
Germany	6.34	-10	31	-70	-72	54
Japan	3.46	22	39	-2	-8	86
Spain	9.14	-58	-56	-290	-275	8
U.K.	8.03	-15	61	-40	-44	79
U.S.	6.67	34	110	-39	-39	115

Exchange Rates

Versus U.S. Dollar, % Change

Country (April 30)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12 Mo. Lo
Australia ($)	8.73	1.6%	6.7%	8.5%	0.6%	11.0%
Canada ($)	1.36	0.4%	0.1%	-0.5%	-2.5%	1.6%
France (*f*)	5.17	-2.7%	-5.2%	-5.0%	-8.6%	0.2%
Germany (DM)	1.53	-3.8%	-6.5%	-10.3%	-12.1%	0.1%
Japan (¥)	104.4	2.7%	-0.9%	-23.8%	-26.1%	4.0%
Spain (₧)	127.3	-2.5%	-4.6%	-3.3%	-7.7%	0.1%
U.K. (£)	1.50	-1.6%	-3.0%	-6.8%	-7.1%	-0.1%

LOOKING FOR GLOBAL RECOVERY

At issue, really, is the consensus prediction that economic growth in the industrialized countries will pick up again in the second half of this year. The markets like to play specific stories to excess, and the current situation is no exception. At present, the major theme is German economic weakness versus U.S. economic strength, and corresponding changes in the interest-rate outlook for the two economies, as well as for the dollar and the DM.

With lightening speed, the view of the situation in the United States has swung from expecting sluggish growth, persistent low inflation and further Fed easing, to anticipating that above-trend growth (i.e. in excess of 2%) will trigger wage and price pressures in an economy already running close to full-employment levels, forcing the Fed to tighten. Such a development would intensify the carnage in the bond market, pushing the 30-year yield well above 7%.

In Europe, meanwhile, the economic indicators remain decidedly on the weak side. But government officials, as well as bank and broker analysts, prefer to conjure up an impending economic recovery.

As usual, the main stimulus is expected from strong exports, driven by accelerating U.S. economic growth and the continuing boom in the developing world. Domestically, additional support is expected from the marked monetary ease that has taken place, and from new inventory building, which in 1994 contributed almost a full percentage point to the EU's GDP growth of 2.7%.

The only people in Europe who fail to share this general optimism are those upon whom its validation ultimately rests, namely business people and consumers. A just-published survey by the European Commission points to a continued erosion in business confidence. "Industrialists took an even more unfavorable view of their business situation in February than in the previous month," the report notes. "They were distinctly more pessimistic about domestic and export order books. At the same time, complaints persisted of excessively high stocks of finished products."

Yet in the rosy consensus view prevailing in the markets, economic and monetary developments around the world add up to a pronounced, synchronized global recovery in the second half of 1996. While negative for bonds, this probably would be highly positive for corporate profits, and consequently for stocks.

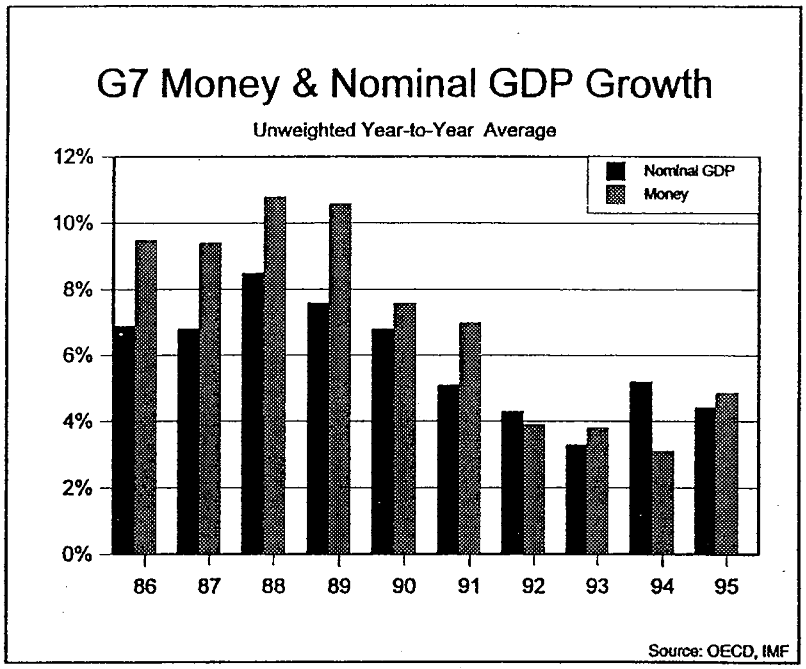
Not everyone agrees, however. In its most recent semiannual World Economic Outlook, the International Monetary Fund cut its growth forecasts for both Europe and North America. U.S. growth now is expected to slow to 1.8% this year

from 2% in 1995. The growth forecast for Germany has been cut to 1% in 1996, down from 1.9% in 1995, while France is seen growing 1.3% in 1995, versus 2.4% in 1995.

Looking at the world economy, the big divide is between the low-investment and low-growth economies of the developed, industrialized countries, and the high-savings, high-investment and high-growth economies of the developing countries of the Far East. Their recent and current rate of output growth of 8-9% compares with a protracted average growth rate in the industrialized countries of just 2%.

THE GLOBAL LIQUIDITY GLUT...

For the time being, to be sure, forecasts of a synchronized recovery in the industrialized countries rest far more on guesswork than on hard evidence and facts. In this context, the main theme in the markets is that the central banks have been deluging the world economy and its markets with liquidity. The initial, welcome effects of this largesse are booming financial markets and recovering economies, but the inevitable, if lagging, result supposedly will be rising price inflation – that is, consumer- and producer-price inflation.



This story tends to begin with the uncontestable fact that global monetary reserves virtually have exploded in recent years, reflecting unprecedented purchases of U.S. Treasuries by central banks around the world. Over the first four months of 1996, these purchases hit a new record high of approximately $200 billion at an annual rate. By comparison, they amounted to $260 billion in the three years 1993-95.

Through their massive Treasury purchases, foreign central banks now are grossly over-financing both the U.S. current-account deficit and the federal budget deficit. For most American and European observers, it is a foregone conclusion that the ensuing steep rise in dollar reserves or international liquidity must fuel world inflation. The first, tangible evidence of this is seen in a sharp upturn in the G7 money supply. The much publicized hikes in commodity prices are regarded as an early symptom of the approaching inflationary surge.

... IS A MIRAGE

To begin with, we apparently need to be point out that European official dollar reserves have changed very little in recent years, implying that liquidity creation from this source has been absent. The dollar-buying binge has been centered in Japan and the developing countries. The world's biggest single dollar holder now is Japan, with well over $200 billion. Next in line are central banks in Taiwan ($90 billion), the People's Republic of China ($75 billion), and Singapore ($68 billion), and the monetary authority in Hong Kong ($65 billion).

The principal single reason why these banks add to their dollar reserves is their desire to prevent or slow an appreciation of their currencies against that of the United States, their most important trading partner. While the dollar buying of the Asian developing countries invites a comparison to that of Japan, there is a crucial difference. In Japan's case, the dollar influx stems from its huge trade and current-account surpluses. In the case of the Tiger countries, however, their huge dollar purchases and associated rapid reserve growth are caused by capital inflows – mostly "hot money" – grossly in excess of their aggregate current-account deficit, which is relatively small.

For good reasons, the stories of a developing global dollar and liquidity glut focus on the Bank of Japan. Concretely, Japanese cash has been pouring through two channels into world financial markets, mainly U.S. markets. Through one of these channels flow the Bank of Japan's own large-scale dollar and Treasury purchases. Through the other pour the huge yen borrowings of domestic and foreign speculators, who have financed their holdings of higher-yielding European and U.S. bonds by borrowing in Japan's money markets at the rock-bottom rate of 0.5%.

Unfortunately, international liquidity is a very hazy concept. What really matters are the economic and monetary effects of such dollar purchases on the financial systems and economies of the countries concerned. The crucial correlation is between changes in foreign-exchange reserves and bank reserves in the form of central-bank balances. The latter serve as the base for domestic credit expansion.

Focusing first on the U.S. side, these massive dollar purchases by foreign central banks obviously lift the dollar and lower interest rates. However, they add nothing to the U.S. money supply. The fact of the matter is that the Bank of Japan doesn't create dollars. What really happens is that the BoJ recycles the dollar inflow from Japan's trade surplus. In the last analysis, this dollar recycling simply reverses the contractive effect that the U.S. current-account deficit otherwise would have on the U.S. money stock.

We also see no evidence of any great monetary reflation in Japan itself. A modest expansion of the Bank of Japan's balance sheet on a year-over-year basis derives exclusively from a jump in currency in circulation matched by a corresponding purchase of government bills. Instead of hailing the associated rapid rise in M1 as evidence of successful reflation, we see it mainly as an outgrowth of the banking scare and the decreased willingness of Japanese savers to hold bank deposits.

Turning to the balance sheets of Japan's commercial banks, we still don't see anything that resembles effective reflation. Total bank loans and discounts show a scant rise of 1.3% against a year ago – probably the most miserable record of credit expansion in the entire world. Growth of broad money continues at a moderate annual rate of 3%.

What has created this misperception of a wall of money waiting in Japan to flood the world? We suspect it is simply the startling coincidence of the BoJ's persistent huge dollar purchases and the abysmally low Japanese money-market rate. By themselves, these appear to signal extreme conditions of monetary ease.

THE CARDINAL ERROR

In this respect, one popular perception in particular needs rectification. It concerns the supposed domestic reflationary effects of the BoJ's endless dollar purchases. An important part of traditional textbook wisdom is that rising foreign exchange reserves – by adding to bank reserves – tend to generate a multiple domestic credit expansion.

Over time, however, the major central banks have learned to sterilize their foreign-exchange interventions when they wish to do so. In fact, in two big countries, Britain and Japan, monetary sterilization of foreign-exchange inflows is built into the system automatically. In contrast to the practice in other countries, both the Bank of Japan and the Bank of England buy and sell foreign currencies not for their own accounts but for those of their governments.

As a consequence, in both countries it is the government, not the central bank, that holds foreign-exchange reserves, with the further implication that it is up to that government to finance any reserve accumulation. To this effect, governments must borrow in the markets by issuing and selling a corresponding amount of domestic-currency debt.

In Britain, this intervention system was introduced in 1932, shortly after the pound was floated off the gold standard. The explicit purpose was to insulate the domestic credit structure against external influences by preventing gold movements from having any effect on bank reserves, which would have resulted if the Bank of England had continued to finance foreign-exchange interventions. This purpose was, in fact, fully achieved.

Whether this particular method for funding interventions involves any deposit or money creation depends entirely on the kind of institutions that acquire the newly issued debt, and on how those purchases are financed. To create money

always requires bank financing. The fact that Japanese broad money now is rising at an annual rate of merely 3% leaves little doubt that Japan's huge official dollar purchases indeed are being fully sterilized. Those purchases therefore have no reflationary effects, neither domestically nor globally. Failure to realize this is the cardinal error in the popular perception of the Japanese wall of money.

THE DILEMMA OF THE TIGERS

An entirely different situation confronts the newly industrialized or industrializing Asian countries. Their soaring foreign-exchange reserves reflect excessive capital inflows, particularly from the United States. For competitive reasons, the Tiger countries are unwilling to tolerate the currency appreciation and the trade deficits that otherwise would be required to absorb those inflows. For it is axiomatic that there can be no net inflow of capital into a country without a corresponding current-account deficit.

No less importantly, these countries, with their modest government debts, lack the deep and broad bond markets needed to absorb the substantial bond sales to nonbanks that would be required to sterilize their massive accumulation of foreign exchange. Besides, sterilization would be extremely costly, as dollar interest rates are far below prevailing domestic interest rates in the Tiger countries. In effect, their central banks would be swapping high-yielding securities for low-yielding ones.

By recycling their dollar holdings into the U.S. Treasury markets, the central banks of the Tiger countries forestall any effects of undesired capital inflows on their currencies and trade balances. In terms of exchange rates, the inflows virtually are cancelled. But failure to sterilize those inflows implies the creation of an equivalent amount of domestic liquidity, with which foreign investors or lenders finance their vast asset purchases in the Tiger economies and financial markets.

During 1990-95, the Asian developing countries had in aggregate 8% average annual real GDP growth and 9% average annual consumer inflation, associated with rampant asset inflation, particularly in real estate. Considering the long track record of prudent macroeconomic management in these high-growth, high-savings countries, we think their huge, non-sterilized dollar interventions have played a crucial role in fueling domestic inflation.

MONEY HAS DECOUPLED FROM GDP

Returning to the industrialized countries, we remain unmoved by the alarm bells currently ringing in the markets over sharply accelerating money growth. The inflation bears fear this as the harbinger of stronger economic activity and higher inflation. We do not share those concerns.

It is true that broad money in the industrial world now is growing faster than at any time in the 1990s. But the consolidated figures mask substantial differences between the individual countries of the G7. A closer look, in fact, reveals that the recent, rapid acceleration in G7 broad money is centered in two major countries, Great Britain and the United States.

In Britain, M3 is up 10% year-over-year, while in the United States M3 has risen 7%, with a marked acceleration in the last three months to a 9% annual rate of increase. What's more, these growth rates are far in excess of nominal GDP growth.

Oddly, though, U.S. nonfinancial credit growth has put in a precisely opposite performance. It has decelerated from 5.1% over the past 12 months to an annual rate of 3.9% in the past three months. Which of the two is the better measure – total credit growth, or the changes in the public's holdings of money?

We can only express amazement at the fuss suddenly being made again about the money supply after so many years in which the money aggregates proved utterly unreliable as indicators of economic activity and inflation – particularly

in the United States and Britain.. The table shows the most recent annual rates of change in U.S. money and debt growth versus the simultaneous growth of nominal U.S. GDP.

Rates of Change for U.S. Money, Debt and Nominal GDP

	1991	1992	1993	1994	1995
M1	8.6%	14.2%	10.2%	1.8%	-2.1%
M3	1.3%	0.2%	1.5%	1.6%	6.1%
Debt	4.5%	4.8%	5.3%	5.1%	5.2%
Nominal GDP	3.0%	5.5%	4.9%	5.8%	4.6%

Source: Council of Economic Advisors

If these numbers reveal anything at all, it is the complete absence of any effective correlations. Peculiarly, in 1992-94, while the U.S. economy was recovering from recession, broad money crawled along at the slowest pace in decades. M1, though, spurted. Yet since early 1995, the pattern has been reversed. Broad money has taken off, while economic activity, as measured by nominal GDP, has slowed. M1 growth now is extremely weak, although that trend has been heavily distorted by the growth of bank "sweep accounts."

The result of these gyrations, of course, is an unprecedented volatility in money velocity. Given this experience, we think that changes in money growth no longer can be taken at face value. To appraise the actual effects of changes in any of the monetary aggregates now requires an investigation of the underlying causes, upon which the parallel changes in money velocity largely depend. The task at hand is to ascertain the forces that evidently have broken the former close relationship between money growth, GDP growth and inflation.

The first general explanation is the recurring, marked shift in lending activities from banks, on the one hand, to capital markets and non-bank financial institutions, on the other. One has only to look at the explosive growth of securitized debt markets to see an example of the degree to which U.S. credit growth has been detached from bank lending.

From a monetary perspective, the shift to non-bank financing makes a tremendous difference. Only bank lending, through the associated deposit creation, increases the money supply. By contrast, other forms of lending leave the money stock unchanged. Instead, they accelerate money velocity, as the existing money supply is used more intensely .

In terms of the economic effects, however, there is no difference between the various forms of lending. Either way, money is borrowed and, having been borrowed, the safest thing to say is that it will be spent.

THE MONETARIST FALLACY

But spent on what? That's really the key question. Borrowed money – whether newly created by banksor recycled by nonbank lenders – can be spent on either of two things: goods and services from current output, or existing capital assets. Purchases of the goods and services add to GDP, while the trading of assets does not.

The crucial fallacy of the American monetarist concept is that it links money growth exclusively to the GDP-related demand for goods and services, and to the prices of those items. This assumes a fixed distribution of money demand between the two markets. But the rampant growth of leveraged speculation and corporate acquisitions in the Anglo-Saxon countries has completely shattered that assumption. More and more money now is diverted into the financial markets. To use the terminology of Keynes, there has been a shift between the industrial and the financial circulation of money.

To us, the entire current discussion about inflation is full of irony. We have long challenged the general complacent view that inflation is dead, arguing that it is in reality quite rampant, but has migrated from goods and services to financial assets – or from Main Street to Wall Street, as we noted in the headline of our December letter.

In the same vein, we constantly have challenged the view that the Federal Reserve deserves both credit and praise for preempting inflationary threats with its allegedly smart policies. At the moment, we don't see any monetary restraint at all on lending, either in the United States or in any other industrialized country. In this respect, we side with those who are presently sounding the alarm about inflation. Monetary policies *are* easy, virtually everywhere. But in trying to assess those policies, we must distinguish between the stances taken by the central banks and their actual effects on the real economies.

CENTRAL BANKS PROPOSE, BUT COMMERCIAL BANKS DISPOSE

In our opinion, most market gurus today focus entirely too much attention on the actions of the central banks and entirely too little on the actions of commercial banks. Whether or not central-bank action will have the desired economic effect depends ultimately on the response of the banking system. It has happened before that a policy of aggressive central-bank easing has been thwarted by a banking system that fails to expand.

The most obvious and extreme example is Japan. Virtually all room for maneuver in easing monetary policy has been used by the Bank of Japan, yet bank lending remains dead in the water, as we explained earlier.

The same question poses itself now in relation to the progressive easing of monetary policy in Europe. Given the structural problems of the European economies, we suspect that they, too, will respond sluggishly. As we have always expected, the main beneficiaries for the time being are the financial markets. European monetary ease, led by the Bundesbank, has added new fuel to financial-asset inflation. European stock prices are hitting one record high after another. Money is plentiful, but it has a marked preference for financial assets, which seem to promise returns of an opulence that is simply unattainable in the more mundane world of industrial production.

Could surging commodity prices indicate a dawning shift from financial-asset inflation to conventional producer- and consumer-price inflation? For that to happen, we think, economies would need to boom. However, we see no signs of that in Europe, Japan or the United States. The commodity shock, far from stimulating economic activity, is more likely to act as a depressant on economies that already are sluggish and vulnerable.

HOW STRONG IS THE U.S. ECONOMY?

Of the major industrial countries, the United States is the only one not clearly mired in subpar growth. Yet while optimistic predictions now abound, we remain more than doubtful. We find serious flaws with the major arguments underpinning those forecasts. These relate to three trends: the U.S. consumer borrowing binge, the ongoing inventory adjustment, and the sharp acceleration in money growth.

Last year, U.S. consumers matched an increase in current income of some $350 billion with a rise in indebtedness of $373 billion. In other words, for each dollar in added income, they added more than a dollar in new debt. Yet consumers spent only $225 billion on current consumption, and a further $9 billion on single-family homes. Apparently, U.S. consumers now require massive quantities of debt just to pay the interest on past debt. It is also possible that consumers are borrowing to pay their bills, while channeling a larger share of their own earnings into the stock and bond bubble. Either way, the implications for the markets and the economy are ominous.

There is widespread agreement that the predicted strong rebound of the U.S. economy later this year will crucially depend on the willingness of consumers to continue their borrowing binge. In the consensus view, this is not in doubt. The usual argument is that consumers are not financially stressed, despite the surge in debt creation, because household balance sheets have been shored up by the powerful rallies in the financial markets. Stock and bond prices last year added $3 trillion to household wealth, grossly outpacing debt growth.

Ever since we first heard this argument, we have doubted both its seriousness and its validity. To make sense of it, one has to assume that the borrowers and the owners of booming financial assets are largely identical. To us, this

always has seemed an absurd idea. At long last, this question has been investigated in a comprehensive study recently published by the Brookings Institute.

The study confirms what we have long suspected. Stock ownership increased from 33% of all U.S. households in 1983 to 37% – or 36 million – in 1992. But despite the widely publicized proliferation of mutual funds, 401(k) plans, cash management accounts, etc., the bulk of household stock holdings are small potatoes. In 1992, fully 77% of all equity holdings were held by 5% of all private households. In other words, the perception that the soaring indebtedness of the consumer has been offset by huge wealth effects is just another mirage.

INVENTORIES ARE NOT "LEAN"

The second major argument in favor of a U.S. economic rebound concerns the inventory cycle. To a large extent, last year's slowdown reflected frantic attempts by businesses to curtail an inventory overhang that emerged in late 1994. Yet inventories continued to climb, albeit at a slower pace. As a ratio to final sales, they have remained high since.

It is well known that inventories play a main role at turning points in the business cycle, but also is well known that they lag rather than lead final demand growth. In this light, the current, high-riding hopes that a reversal in the inventory retrenchment will be kind enough to pull economies both in Europe and North America out of their current doldrums do not appear to us to be very reasonable.

What then, about the alleged monetary signals – that is to say, the rapid acceleration in U.S. broad money growth that started in late 1994 and early 1995, and that has played such a prominent role in the current expectations of an impending U.S. economic rebound? We regard it as the weakest argument of all. Closer scrutiny reveals that this monetary expansion is yet another mirage. It brings us back to our previous observation: While money has taken off, credit has slowed.

U.S. Bank Deposit and Credit Growth and Total Credit Growth
Billions of Dollars

	1990	1991	1992	1993	1994	1995
Checking Deposits	21.7	37.6	92.8	74.1	-31.7	-46.0
Small Time Deposits	123.0	78.9	2.7	-11.9	-1.1	113.2
Large Time Deposits	-66.1	-58.5	-73.2	-23.5	19.6	80.5
Bank Credit	130.1	105.1	115.2	162.6	156.8	271.5
Total Credit	619.4	480.6	545.3	625.9	617.0	716.7
Bank Share of Total Credit	19.4%	21.9%	21.1%	26.0%	25.4%	37.9%

Source: Federal Reserve

As shown by the table on page 7, the U.S. monetary picture in recent years is unusually checkered. Still, to understand the situation, it is indispensable to understand *all* the relevant monetary trends. To this end, we have focused on three aggregates: total non-financial debt, bank credit, and bank funding. The relevant facts are highlighted in the table above.

The first important trend to see is the shift in U.S. credit activity back to banks from the financial markets and nonbank lenders. The bank share of total credit growth rose to 38% in 1995, from 25% in 1994 and a low of 19.4% in 1990. The second crucial point is that recurrent shifts in bank funding have caused gross distortions in the monetary aggregates.

Normally, bank deposits (the main components of the money supply) and bank loans move in lockstep. But the 1990s have been the great exception in this regard. Between 1990 and 1994, banks slashed their deposit growth by switching their funding heavily to security repos and Euroborrowing. Since neither repos nor term Eurodollars are counted in monetary aggregates, the net effect was a collapse in U.S. money growth. But the economy recovered nonetheless, driven by soaring credit.

All this changed radically in 1995. Last year, U.S. banks switched their liability structure back toward deposits, adding no less than $193.7 billion in time deposits to their balance sheets, compared to $18.5 billion in 1994 and a net reduction of $35.4 billion in 1993. It is this shift which explains the sudden boost to the money supply.

On the surface, this shift in funding back to deposits has tremendous monetary implications, since deposit growth – in contrast to repos and Euroborrowing – adds correspondingly to the money supply. For the economy, however, the relevant aggregate is credit creation, no matter how it is funded. This accelerated only slightly last year, with total nonfinancial debt growing 5.4%, compared to 4.9% in 1994.

Credit is the main instrument that creates the opportunity to spend beyond current income. Accordingly, the crucial importance of strong credit growth for the U.S. economy cannot be minimized. The particular method used to fund that credit growth, on the other hand, is of relatively little importance. Looking at U.S. consumers, for example, who would seriously argue that the quantity of their cash holdings is more economically significant than the size and duration of their borrowing binge?

The bottom line is that the consensus forecast of a U.S. economic rebound is on extremely shaky ground. Even if the expansion survives, it will remain sluggish enough to stave off any thought of a monetary tightening by the Fed. Instead of fueling general inflation, higher commodity prices instead will haunt the markets and weaken the economy.

GERMANY'S ECONOMIC PREDICAMENT

As we said earlier, the great current theme in the financial markets is the U.S. economy's singular strength versus the German economy's sluggishness. But in our opinion, there is no locomotive in sight to drive the U.S. economy forward. The reality of economic sluggishness is obscured by obviously transitory sources of strength. It may, however, be some time before the statistics make this evident.

Germany's economic predicament, on the other hand, is visible and well publicized. German analysts, public and private, are competing openly in downgrading their forecasts. A 1% growth rate in 1996, which would have seemed excessively pessimistic a year ago, now is regarded as optimistic. A very strong pickup in the second half would be required to achieve it. As German economic growth is highly labor extensive, this implies still higher unemployment.

Most of the positive growth forecasts for Germany rely heavily on lower interest rates and an accelerating money supply. Yet we think the most important positive change has been the decline of the DM, not only against the dollar and yen but also against the weak currencies in Europe (the Spanish peseta, the Italian lira and the British pound), which have sharply recovered from their precipitous falls in 1993-94. Compared to the currencies of Germany's most important trading partners, the mark has sunk to its lowest levels since early 1995. Actually, German exports have held up remarkably well, given the extremely unfavorable currency conditions of the past two years.

But a favorable exchange rate will not be enough to revive the German economy. Home-made ills, in the form of welfare and wage excesses, are what have ravaged economic growth. These plague the entire economy, while the exchange rate affects only the manufacturing sector. Accordingly, any recovery stemming from a weaker DM will be limited to that sector.

At long last, Chancellor Helmut Kohl has brought himself to reign in the runaway welfare state. His proposed reforms are hailed as the most far-reaching cost-cutting exercises since at least 1983. But in reality, Mr. Kohl has badly lagged public opinion on this issue. Most Germans long ago realized their over-generous welfare system can no longer be financed, even though they are sure to argue about how to distribute the burden of adjustment.

In addition to spending cuts aimed at reducing the fiscal deficit, Mr. Kohl's program prescribes cost savings by Germany's socialized pension and health insurance funds to contain welfare contributions, which are shared by employers and employees. Other measures are intended to reduce Germany's outrageous labor costs and ease the country's tough employment protection rules.

Some of the measures require the consent of the Bundesrat, the upper house of Germany's federal parliament, which is dominated by the opposition Social Democratic Party. Others require the consent of the trade unions. Both are violently protesting against such "social injustice."

Of the two, the trade unions unquestionably are the hardest nut to crack. But they rapidly have been losing both influence and members. Recent, successive wage settlements calling for only 1.8% annual raises do show a new sense of constraint.

Will Mr. Kohl stand his ground this time? Ordinarily, we would tend to doubt it. But he stands with his back to the wall. His reputation in Europe and in the world as a major political leader is at stake.

In other countries, governments already have substantially trimmed their welfare and wage excesses. It can only be hoped that the ossified German model of social consensus is showing the first signs of flexibility. Too often in the past, the government and business leaders have sought agreement with the trade unions at all costs.

THE SPARKLING DOLLAR?

For the past two years running, currency markets have started the year betting on a strong dollar, only to be disappointed. Will the third time prove a charm?

After meandering for a while, the dollar took off in February on the heels of that month's very strong employment report. Basic to this renewed dollar bullishness is the perception that with America's economy growing strongly, its interest rates are more likely to rise this year, while German economic sluggishness will force the Bundesbank into progressive rate cuts. Meanwhile, the Bank of Japan is expected to keep its discount rate at its current, unattractive low level. Last but not least, the dollar bulls continue to bank on a belief that desperate German and Japanese policymakers are willing and able to stop their currencies from rising.

This time, the bullish case has seemed really overwhelming. Yet still it has required unprecedented dollar purchases by foreign central banks to lift the greenback.

Most shocking has been the dollar's recent behavior against the yen. Hopes rode high that the start of the Japanese fiscal year on April 1 would usher in a renewed flood of Japanese capital exports, as investors fled low domestic rates. Yet the dollar, after briefly hitting ¥108.7 in early April, now is struggling at ¥104, suggesting this theory, too, was a false hope.

In the markets, the ready inclination has been to dismiss the dollar's weakness as the result of mistaken speculation that a nascent Japanese economic recovery would lead to a BoJ rate hike. But to us, another explanation appears far more plausible: The large private portfolio outflows from Japan to the United States needed to lift the dollar against the yen have failed to materialize. While low domestic interest rates should encourage capital outflows, the balance-sheet problems in the financial sector are blunting the appetites of Japanese investors for foreign assets.

What actually have propped up the dollar have been the huge dollar purchases of the central banks, and the speculative orgy of the global yen-carry trade. As we have explained in past letters, hedge funds, dealers and financial institutions around the world have boosted bond prices and the dollar with enormous leverage using ultra-cheap borrowed yen. Now that those positions have gone sour, participants are steadily closing them out. At the same time, it may well be that the Bank of Japan is putting a cap on its purchases as well. If true, this would mean that the dollar rally against the yen is over.

As we have so often stressed, particularly in our last letter, the decisive, negative fundamental for the dollar is the enormous U.S. current-account deficit. While relatively modest compared to U.S. GDP, it is simply far too big to be financed by foreign private investors – even leaving aside the additional balance-of-payments gap created by large U.S. capital outflows. It has required ever larger dollar purchases by foreign central banks to fill the gap.

A truly strong dollar will require a big fall in America's current-account deficit, not just low Japanese and German interest rates. But that will not happen until Americans stop spending more than their income, which by definition is what a current-account deficit expresses.

CONCLUSIONS

If strictly left to market forces, the dollar's rally would have very narrow limits for three main reasons:

- Too many investors and speculators already are positioned for a dollar up move.
- Speculators continue to unwind their long dollar positions from the yen-dollar carry trade.
- U.S. financial markets are less attractive now compared to European and Asian markets.

It is always possible that foreign central-bank dollar buying will tip the balance. But absent such support on a massive scale, we expect the dollar's weakening trend to resume. What might be the catalyst? The most likely source will be accumulating signs that the U.S. economy is turning sluggish, rather than rebounding. This would once again raise the prospect of Fed rate cuts, instead of the rate hikes presently discounted in the markets.

In principle, sluggish growth ought to be bullish for U.S. bonds. But we are reluctant to endorse that view because the Treasury market, far more than any other, is dominated by central banks and massive short-term speculation by hedge funds, brokers and dealers using borrowed money. Those are the players that funded last year's bull run. In reality, as a low-saving, high-consumption, highly indebted nation with a chronic current-account deficit, U.S. bonds yields ought to be high.

In the European bond markets, investors once more are playing the convergence game. Betting that governments will, under any circumstances, impose EMU, if necessary by adopting a loose interpretation of the Maastricht criteria, investors are pouring money into the high-yielding bonds of the soft-currency countries. This has prompted a renewed narrowing of spreads against German Bunds, and a strengthening of these currencies. This, too, has weakened the DM.

The main danger for the industrialized economies is sluggishness, not overheating. Borrowing, now running at extremely high levels, appears highly inflationary. But it is disproportionately concentrated in asset markets, having switched over the course of the 1990s from overheated speculation in residential and commercial real estate to equally overheated speculation in bonds (yield-curve playing) and stocks (merger mania).

It is true that there is inflation and overheating in the world today, but it is in the financial markets, not the real economies. That is where the dangers loom.

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